Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Treatment of Warranty Obligation Reserve As Section 475 Losses

This Chief Counsel Advice responds to your request for assistance dated January 8, 2015. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Year 1 =
Year 2 =

ISSUE

Whether the book reserve losses reported by Taxpayer with respect to its repurchase and indemnity obligations arising from the breach of mortgage sale contract warranty and representations (W&R Obligations) were properly treated as section 475 mark-to-market losses on securities.

CONCLUSION

The book reserve losses reported by Taxpayer from its repurchase and indemnity obligations arising from the breach of W&R Obligations were not properly treated as section 475 mark-to-market losses on securities.

FACTS

Taxpayer originated and sold mortgages prior to and during years under audit to private investors and other large purchasers. Under the terms of the sales contracts or other relevant documents, purchasers were generally entitled to force the repurchase of the mortgages by Taxpayer and/or pursue other indemnification from Taxpayer to compensate for Taxpayer's (or other originator's) breach of warranties and representations that caused the value of the mortgages to be materially and adversely impaired. Typically asserted defects included those involving failures to follow proper underwriting or valuation standards. Taxpayer made numerous representations and warranties related to the appraisal, insurance, underwriting and general quality of the mortgage loans and the underlying mortgaged property.

The agreements generally prescribed procedures by which Taxpayer had to make purchasers whole for any material breach, including providing purchasers the right to demand Taxpayer to repurchase defective mortgages and indemnify the purchaser for costs. Some purchasers had a formal process by which they would request review of mortgage files associated with defective mortgages. The full process allowed for appeals and the negotiation over remedies, independent of forcing the repurchase of defective mortgages. Taxpayer expended considerable resources challenging repurchase demands, frequently averting repurchase with its appeals.

The parties to the representative agreement stipulated that Taxpayer's obligations to cure, substitute or repurchase defective mortgage loans and to indemnify the purchaser constituted the sole remedies respecting Taxpayer's breach of its warranties. The agreement stipulated that, unless otherwise agreed to by the purchaser and Taxpayer, the repurchase price was the stated principal balance of the relevant mortgage, unpaid stated interest, plus all reasonable and necessary costs incurred by the purchaser that arose from the breach. Any cause of action related to breach of the W&R Obligations accrued upon (a) discovery of the breach by the purchaser or notice given by Taxpayer, (b) failure by Taxpayer to cure or repurchase, and (c) demand by the purchaser that Taxpayer comply with the agreement.

The representative agreement expressly stated that Taxpayer's intent was to undertake a sale of mortgages and not the issuance of a debt instrument or the sale of another security. It further stated that the parties intended to treat the transactions for accounting and Federal income tax purposes as sales of mortgage loans. The agreement made provision for payment of the purchase price of mortgage loans at closing, but not for the payment of premium for the purchase of options. Consistent therewith, the W&R Obligations were not reported or described as securities in Taxpayer's public reporting.

For book purposes, Taxpayer estimated and reported an aggregate loss reserve for its W&R Obligations. In calculating the reserve, which it determined on an undiscounted basis, Taxpayer evaluated trends in defaults, repurchase demand activity, successful

appeal rates, actual losses, market conditions, and such other factors that it judged significant.

Taxpayer's Position -- Taxpayer contends that the W&R Obligations were securities under section 475(c)(2)(E). In filing its Year 1 and Year 2 returns, Taxpayer took the position that its aggregate reported book loss reserve for its W&R Obligations represented section 475 mark-to-market losses on securities. Taxpayer maintains that, "as part of each sale, the purchaser acquires a derivative right to put the loans back to Taxpayer for originations that are defective and breach the representations and warranties in the sales contracts." In essence, Taxpayer contends that the sales contract remedies, which include the right of a purchaser of mortgages to demand repurchase for breach, should be viewed as separate securities upon which gain or loss is determined under section 475.[1] It follows from Taxpayer's argument that the purchasers of the mortgages not only acquired the mortgages in the sales contract but also purchased separate put options on such mortgages.

LAW AND ANALYSIS

For an accrual basis taxpayer to properly claim a deduction for a liability, the liability must be incurred; that is, it must meet the all events test and economic performance requirements in section 461(h) and Treas. Reg. § 1.461-1(a)(2). A liability is incurred in the taxable year in which (1) all the events have occurred that established the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. Treas. Reg. §§ 1.461-1(a)(2) and 1.461-4.[2]

A securities dealer is generally required by section 475(a)(2) to mark any security which it holds at the close of the taxable year so that such dealer recognizes any gain or loss as if such security were sold for its fair market value on the last business day of such taxable year. Section 475(a) requires that proper adjustment shall be made in the

[1] It is not known whether Taxpayer would contend that the W&R Obligations should be viewed as puts on pools of mortgages or, perhaps more consistent with the definition of an option, a series of options on each sold mortgage in a pool.

[2] The reserve for warranty losses on the sale of the mortgages would not be properly treated as either a deduction or reduction of sales price. See Bell Electric Co. v. Commissioner, 45 T.C. 158, 166 (1965) (declining to follow Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956)):

> [T]he basic question is simply whether a taxpayer may exclude from current income amounts actually received or accrued merely because future expenditures may offset such amounts in part or in whole. The statute does not permit the deferral of such income to be offset in a later year by expenses incurred in that later year; nor does it permit the same result to be reached by excluding a portion of the receipts from current income through the medium of crediting such excluded amounts to a reserve for future expenditures which are thus in effect deducted prior to the time they are actually made or incurred.

See generally United States v. General Dynamics, 481 U.S. 239 (1987).

amount of any gain or loss subsequently realized for gain or loss taken into account by the mark.

A dealer in securities is defined by section 475(c)(1) to be a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

Section 475(c)(2) broadly defines the term “security.” As relevant here, a security includes a note, bond, debenture, or other evidence of indebtedness as described in section 475(c)(2)(C). Under section 475(c)(2)(E), a security further includes an evidence of an interest in, or a derivative financial instrument in any security described in section 475(c)(2)(C), or any currency, including any option, forward, contract, short position, and any similar financial instrument in such a security or currency.

The W&R Obligations Were Not Section 475 Securities

The W&R Obligations were not securities described in section 475.

Taxpayer Should Not Be Permitted To Disavow the Form of Its Transaction

Taxpayers generally are bound to the form of their transactions. See Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). The Service, however, is not necessarily so bound and can make adjustments to reflect a transaction’s true substance. Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); Knetsch v. United States, 364 U.S. 361, 366 (1960); Interlochen Co. v. Commissioner, 232 F.2d 873, 877 (4th Cir. 1956) ("[T]he Commissioner or the courts may look through the form of a transaction to the substance thereof," but the choice to disregard its classification of a transaction "does not lie with the taxpayer").

In form, Taxpayer’s W&R Obligations were standard provisions in mortgage sales contracts designed to provide purchasers compensation for Taxpayer’s failure to deliver mortgages of the quality that the purchasers bargained for. The W&R Obligations were material and integral to the sales contracts, not independent financial instruments, investments, positions or bets on the value of those mortgages. The value of the W&R Obligations was generally derived from the mortgage loans, but that value was not realizable but for a breach by Taxpayer of a relevant obligation, discovery and failure to cure. Thus, unlike the value of options or similar derivative financial instruments, the value of the W&R Obligation is generally driven by non-market forces including things like discovery of a breach, failure to cure, negotiations and the quality of appeal arguments.

Neither the W&R Obligation terms nor any others in the representative agreement suggest that the parties intended that a separate option (or more aptly, a series of

separate options) or other similar derivative financial instrument was independently entered into, either for Federal income tax purposes or otherwise. Rather, the representative contract specified that the only consideration paid was specifically for the sale of mortgages. No separate option premium was paid. Consistent therewith, the contract included a representation by Taxpayer that it had determined that the disposition of the mortgage loans pursuant to the agreement would be afforded sale treatment for accounting and tax purposes.

Remedy or Damage Provision Rights Are Not Considered Options

Courts have repeatedly rejected the notion that rights to liquidated or other damages in a bilateral sales contract cause such contracts to be treated as options.

The Tenth Circuit opinion in W.A. Drake v. Commissioner, 145 F.2d 365 (10th Cir. 1944) is perhaps the most analogous and instructive case to the facts at hand as it involved a seller of property claiming that a sales contract that included unwind and liquidated damage provisions should be treated as an option. The taxpayer in W. A. Drake sold a farm pursuant to a contract of sale that contained a liquidated damages provision that gave the taxpayer, as the seller, the right to keep any sales proceeds paid up to the point of the purchaser's breach of its obligation to make ongoing timely payment of deferred sale proceeds, at which time the purchaser would be obligated to return the farm to the taxpayer. The taxpayer claimed that the purchaser had merely entered into an option to purchase the property, as the purchaser's default caused the property to be returned to the taxpayer. The Tenth Circuit was not convinced. The court looked to the "entire contract"[3] to conclude that the sales contract created enforceable obligations and was more than just a mere option to purchase. In particular, it stated that, "the right to cancel [unwind the sale] in the event of default by [the purchaser] did not convert an otherwise binding contract into an option contract." Further, the ability of the purchaser to default and forfeit only the property and proceeds previously remitted was not viewed as a put option.

Other courts have been consistently unreceptive to characterizing executory sales contracts as options based on the operation of damage provisions in those contracts. More particularly, courts have not confused the right to accept or pay liquidated damages as indicating that an otherwise executory bilateral contract should be characterized as an option. The Service failed in United States Freight Co. v. U.S., 422 F.2d 887 (Ct. Cl. 1970), to convince the U.S. Court of Claims that a taxpayer that had forfeited a $500,000 down payment as liquidated damages for its failure to go forward with a bilateral sales contract caused the contract to be an option contract. The court held that the agreement was not an option because options are rights possessed under a unilateral contract and do not arise under failures from bilateral contracts. The Court

[3] At the lower court level, the Tax Court in W. A. Drake rejected the apparent contention by the taxpayer that the sale transaction should be severed into discrete parts. The Tax Court stated that it was not impressed by taxpayer's argument that the sale could be broken up into several parts, concluding that the transaction was only the sale of the farm. W. A. Drake v. Commissioner, 3 T.C. 33, 38 (1944).

of Claims stated, "It is also clear that the insertion of a provision for liquidated damages in the event of plaintiff's breach did not convert the bilateral contract into an option." Id. at 895.[4]

The W&R Obligations Are Not Severable Put Options

Generally, the Service and courts have refused to treat embedded rights in contracts or financial instruments as options. The bifurcation of convertible debt into debt and an option on equity was rejected by the Court of Appeals for the Second Circuit in Chock Full O' Nuts Corp. v. U.S., 453 F.2d 300 (2d Cir. 1971). The taxpayer therein argued that the convertible bonds could be bifurcated because convertible debt is analogous to bond-warrant investment units, which have been recognized under the tax law to contain two distinct and divisible obligations. The court rejected the taxpayer's argument because bond-warrant investment unit components are sold separately on the market, whereas convertible bonds are indivisible units. Chock Full O' Nuts, 453 F.2d at 305. Further, the court stated that a holder could exercise a bond-warrant investment unit without forfeiting the bond, while a holder of a convertible bond must forfeit the bond in order to exercise the conversion feature.

Similarly, the Tax Court in Hunt Foods and Indus., Inc. v. Commissioner, 57 T.C. 633 (1972) rejected the claim by a taxpayer, a corporate issuer of convertible debt, that it could effectively bifurcate convertible debt into both debt and an option so as to allocate part of the debt issuance proceeds to the option feature. Hunt Foods, 57 T.C. at 634. The court rejected the corporation's contention, stating that an investment unit contains two separate securities: an obligation and an option, which are legally and physically independent of one another and have their own separate markets. Id. at 642. By contrast, the court viewed the convertible debt to be a single security because the debt and option features did not have physical and legal independence and could not be sold separately. Cf. Rev. Rul. 88-31, 1988-1 C.B. 302 (a put option that was issued as part of an investment unit was considered a separate item of property where it was separately transferrable after a short period of time); Rev. Rul. 2003-97, 2003-2 C.B. 380.

In the case at hand, the W&R Obligations were physically and legally dependent and intertwined with the sales contracts. The W&R Obligations were not designed to be separately assignable and they would not have existed but for the sales contracts. The W&R Obligations and associated remedy rights preserved the value of the bargain struck in the sales contracts, making the terms mutually interdependent. Any attempt to bifurcate the contracts into sales of the mortgages plus options would be inconsistent with the terms of the contracts and economic realities.[5]

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[4] See also Halle v. Commissioner, 83 F.3d 649 (4th Cir. 1996)(the ability to walk away from a sales contract by forfeiting a deposit, though resembling an option, is merely part of a bilateral sales contract).

[5] The court in Hunt Foods also expressed concern that bifurcating the convertible debt would have been "contrary to the practice that has apparently generally been followed throughout the years and ignores the realities of a convertible debenture." Id. at 641. A similar concern would arise here if warranty provisions in sales contracts were viewed as separate items of property independent from the sales contracts as the

Based on the above, the W&R Obligations were not section 475 securities; therefore, the W&R Obligation reserve losses were not permitted to be taken as section 475 mark-to-market losses by Taxpayer during the years in question.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

No opinion is being expressed on any aspects of this issue except as addressed above. Thus, this should not be read to express or imply an opinion on the treatment of contingent options under the Federal income tax law. Further, this advice does not express an opinion on whether Taxpayer's estimated aggregate loss reserves would be considered to be an accurate determination of its mark-to-market losses even if the W&R Obligations were considered section 475 securities.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Grace Cho at (202) 317-4424 if you have any further questions.

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established tax accounting for expenses of satisfying sale warranties would be upended for section 475 dealers and traders.